IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In Re Enron Corporation Securities, Derivative & "ERISA Litigation	§	MDL-1446
THIS DOCUMENT RELATES TO: All Cases	§	
MARK NEWBY, ET AL., Plaintiffs	§	
VS.	§	CIVIL ACTION NO. H-01-3624 CONSOLIDATED CASES
ENRON CORPORATION, ET AL., Defendants	§	
THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, ET AL., Individually and On Behalf of All Others Similarly Situated, Plaintiffs,	§	
VS.	§	
KENNETH L. LAY, ET AL., Defendants.	§	

MEMORANDUM AND ORDER RE

REMAINING ENRON INSIDER DEFENDANTS

The above referenced putative class action, brought on behalf of purchasers of Enron Corporation's publicly traded equity and debt securities during a proposed federal Class Period from October 19, 1998 through November 27, 2001, alleges securities violations

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(1) under Sections 11 and 15 of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. §§ 77k and 77o; (2) under Sections 10(b), 20(a), and 20A of the Securities and Exchange Act of 1934 ("Exchange Act" or "the 1934 Act"), 15 U.S.C. §§ 78j(b), 78t(a), and 78t-1, and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission ("SEC"), 17 C.F.R. § 240.10b-5; and (3) under the Texas Securities Act ("TSA"), Tex. Rev. Civ. Stat. Ann., article 581-33 (Vernon's Supp. 2002)

Pending before the Court *inter alia* are motions to dismiss pursuant to Rules 8, 9(b), and 12(b)(6) of the Federal Rules of Civil Procedure, section 21D(b)(3) of the Exchange Act, as amended, the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), codified at 15 U.S.C. §78u-4(b)(3)(A), and *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), filed by the following Enron Insider Defendants, who are sued under all the statutes identified *supra*.

(1) Ken L. Harrison, Chief Executive Officer of Portland General Electric (an Enron subsidiary) and a director of Enron (#621);

(2) Lou Pai, Chairman and Chief Executive Officer of Enron Accelerator[1] since the end of 2000, after being director of Enron Energy Services ("EES," Enron's retail energy services business), and an

[1] Pai identifies this entity as Xcelerator.

officer and/or director of New Power Corporation (#624);

(3) Richard B. Buy, Executive Vice President and Chief Risk Officer since June 1999, after serving as Senior Vice President and Chief Risk Officer from March 1999 until July 1999, and Management Director and Chief Risk Officer of Enron Capital & Trade ("ECT") from January 1998 until March 1999 (#637);

(5) Joseph M. Hirko, Chief Executive Officer of Enron Broadband Services, Inc. ("EBS") from 1997 until June 2000 (duplicatively filed as #639, #685);

(6) Kenneth D. Rice, Chairman and Chief Executive Officer of EBS (Enron's broadband services business) since June 2000, Chairman and Chief Executive Officer of ECT-North America from March 1997 until June 1999 (#640);

(7) Richard A. Causey, Enron's Executive Vice President and Chief Accounting Officer from January 1997 to February 2002, and an officer and/or director of New Power Corporation (#642);

(8) Jeffrey McMahon, Executive Vice President, Finance and Treasurer since July 1999, after being Senior Vice President, Finance and Treasurer from July 1998 through July 1999 and Chief Financial Officer

of Enron Europe from 1994 through July 1998 (#644);

(9) James V. Derrick, Jr., Enron's Executive Vice President and its former General Counsel since July 1999, and an officer and/or director of New Power Corporation (#649);

(10) Kevin P. Hannon, Operating Officer of Enron Broadband Services, Inc. from January 2000 to June 2001, until his resignation in August 2001 ("EBS") (#655);

(11) Kenneth L. Lay, director, Chairman of the Board of Directors and Chief Executive Officer of Enron, and an officer and/or director of New Power Corporation (#683); and

(12) Jeffrey K. Skilling, director, President and Chief Operating Officer until February 2001, when he became Chief Executive Officer of Enron (#718).

The Court hereby incorporates its summaries of the alleged facts and applicable law in its previous memoranda and orders of December 20, 2002 (#1194), of January 28, 2003 (#1241), of March 12, 2003 (#1269), and of March 25, 2003 (#1299).

Having reviewed the briefing, the Court directly addresses the adequacy of Lead Plaintiff's pleading of its claims against each Enron insider in light of all the circumstances alleged in the complaint.

Ken L. Harrison

Harrison is sued under § 10(b), § 20(a), and § 20A of the Exchange Act; the complaint also alleges violations by Harrison of the Texas Securities Act ("TSA"), relating to two offerings of Enron debt securities, i.e., $250 million of 6.40% Notes and $250 million of 6.96% Notes.

As previously indicated, Lead Plaintiff must replead all TSA claims or inform the Court that it no longer wishes to pursue the claims against one or more Defendants charged with violating the Texas statute.

Harrison was a career executive at Portland General Electric Company ("PGE"), a regulated electric utility, became its Chief Executive officer ("CEO") in 1987, and ran it until March 31, 2000.[2] In 1997 Enron acquired PGE, and Harrison became a member of the Enron Board of Directors, but claims that he did not serve on any Enron committees. Complaint at 67, ¶83(l); at 89, ¶86. Nevertheless the complaint at pp. 91-93 at ¶88 represents that he served on the Management Committee in 1997 and 1998, and the Executive Committee in 1999.

Harrison contends that Plaintiff's only claim against him is that during the Class Period in 2000, while Harrison was in

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[2] Harrison clarifies that Lead Plaintiff incorrectly stated that Harrison left the Board in 2000; he states that he "completed his informal arrangements to leave the Enron Board in 2000, [and] a separation . . . was formally completed on May 1, 2001." #622 at 6 n.10.

possession of adverse undisclosed information about Enron, he sold 1,011,436 shares of Enron stock, or 51.88% of his holdings, for proceeds of $75,416,636. Complaint at 257, ¶ 401; p. 259 ¶ 402.[3] He explains that he only acquired the stock and options when Enron purchased PGE in 1997 and that he sold the stock and options when they became vested, between May and September 2000, all at a prices exceeding three times his option strike price, shortly after he retired from PGE in March 2000 and more than a year before Enron's major restatement of earnings in the fall of 2001. Furthermore he retained almost half of his Enron stock, which he held until the price of the shares had nearly fallen to zero.

In response Lead Plaintiff points to the following allegations in the complaint: (1) Harrison served on Enron's Management Committee from 1997-1999 and on the Board of Directors from 1998-2000 (at 67, ¶83(l); at 91-93, ¶88); and (2) Harrison made false and misleading statements to the market when he signed Enron's Form 10-K's and registration statements filed with the SEC in 3/98, 4/98, 1/99, 2/99, 3/99, 7/99, and 3/01, which all included false financial statements and materially false disclosures about Enron's related-party transactions (¶¶ 109-110, 126, 134, 141, 164, 292,

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[3] Ex. C to Plaintiff's Appendix in Support of Consolidated Complaint (#442) reflects the following other trades:

11/4/1998-7,266 shares at just over $28 per share
2/24/1999-54,000 shares at $33.96 per share
4/30/1999-100,000 shares at $37.50 per share

215-221).

In its memorandum and order of March 25, 2003 (#1299 at 5-11), this Court found that Lead Plaintiff has stated a claim, including the pleading of facts raising a strong inference of scienter, under § 10(b) against those Insider Defendants who not only managed the day-to-day operations of Enron, but who also sat for years on the key Management Committee. The persistent patterns by which the alleged scams of the Ponzi scheme were effected were unmistakable, and any executive sitting for a length of time on the Management Committee, which was repeatedly asked to approve these deceptive devices and contrivances, would have had to be aware of or have recklessly disregarded the warning signs. The Committee members three times approved a waiver of Fastow's [and Michael Kopper's] conflicts of interest, contrary to Enron's own Code of Conduct, and sanctioned the creation of most of the SPEs and partnerships and the illusory transactions among them and Enron, all too frequently and blatantly created at critical SEC-reporting times when Enron was in danger of not "making its numbers" and artfully manipulated by acknowledged, high-risk, aggressive accounting. The complaint paints a picture of these individuals actively and knowingly participating in a corporate culture of brazen ambition toward the appearance of ever increasing success, which was simultaneously being undermined by their blatant self-dealing for personal enrichment. Their greed was rewarded by high salaries,

extraordinary bonuses, and the exercise of Enron stock options or sale of company stock, the value of all of which was continuously inflated by their manipulation of Enron's financial reports. In other words, despite the repetitive patterns of fraud constituting red flags, the Management Committee repeatedly rubber-stamped the deceptive devices and contrivances and practices of SPEs abusive accounting used to move debt off Enron's balance sheet and to claim sham revenue, while providing them with lucrative returns from the alleged Ponzi scheme. Moreover, Lead Plaintiff has shown that these Insider Defendants also sold Enron stock after becoming aware of the company's nonpublic information relating to the scheme while serving on the Management Committee, without disclosure of that information to the shareholders.

These same reasons for finding that Lead Plaintiff has met its pleading burden under the PSLRA as to other Enron insiders previously discussed also apply to Harrison. Moreover, in addition to a fiduciary's insider trading in breach of the duty of disclosure, in its memorandum and order of March 12, 2002 (#1269 at 4-7), the Court concluded that an individual who signs an SEC filing at a time when he knows, or exhibits reckless disregard toward warnings, that it is false or misleading, has "made" a statement for purposes of a primary violation of § 10(b). Lead Plaintiff has stated such claims against Harrison.

Thus the Court finds that Lead Plaintiff has stated § 10(b)

claims against Harrison, for creating deceptive devices and contrivances, for making misleading statements that were filed with the SEC, and for selling a substantial percentage of his Enron stock without disclosing material adverse, confidential information, in breach of his fiduciary duty to Enron's shareholders. Lead Plaintiff has also stated a claim under § 20A for insider trading against Harrison. Moreover, because Harrison's service on the Management Committee and the Board and his voting in those positions demonstrate that he had the power to control Enron's policies and actions, the Court finds that Lead Plaintiff has also stated a controlling person liability claim under § 20(a) against Harrison.

Thus the Court denies Harrison's motion to dismiss, but will require that Lead Plaintiff replead its TSA claim against him.

Lou Pai

Pai is sued under § 10(b) and Rule 10b-5, § 20(a), and § 20A of the Securities and Exchange Act of 1934, but not under the TSA.

During nearly all of the four years between 1997-2000, Pai was President and director of EES and allegedly participated in establishing some of EES' fraudulent deals, discussed below, before becoming Chairman and CEO of Enron Accelerator at the end of 2000. Complaint at 65, ¶83(j). He also sat on the Management Committee in 1997, 1998, 1999, and 2000. Complaint at 91-94, ¶88. The complaint alleges that while in possession of nonpublic information

regarding the fraud at Enron, garnered by his personal involvement in the EES contracts and his participation on the Management Committee, Pai divested himself of 100% of his Enron securities holdings during the Class Period: he sold 3,912,205 shares of Enron stock for $270,276,965 and transferred 57,756 shares, valued at $3,961,973, to Enron to pay the exercise price of options that he was exercising and the related tax withholding so that a substantial portion of the stock proceeds went directly to him. Complaint at 65, ¶83(j); at 87, ¶84; and at 259, ¶402.

The complaint[4] asserts that EES intentionally entered into long-term contracts to provide energy services on which it knew it was nearly certain to lose money because these contracts, by manipulation, improperly and prematurely gave Enron, up front, current-quarter recognition of hundreds of millions of dollars in revenue to boost its current financial results. Functioning as a significant part of the alleged Ponzi scheme, these long-term contracts by their nature were highly speculative and the outcome, indeterminate. Because the energy services had not been provided at the time the long-term contract was entered into, because of the substantial number of variables involved, and because EES lacked an historical performance track record, EES had no basis to forecast accurately or responsibly the energy costs or savings involved.

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[4] *See* complaint at 111-12, ¶ 121(g) and (j); at 126, ¶ 155 (f) and (g); at 195-96, ¶ 300 (f) and (g); at 222-23, ¶339(f) and (g); and at 306-08, ¶¶541-545.

Moreover, Lead Plaintiff contends that by initially and arbitrarily adopting unreasonable, grossly overstated contract valuations and economic assumptions and by abusing mark-to-market accounting, EES recognized all future revenues from a contract in the quarter in which the contract was signed, a violation of GAAP. Then, by "moving the curve," i.e., arbitrarily adjusting the values upward at the ends of subsequent quarters, EES boosted the profits for each such period. To induce customers to enter into such agreements so that Enron could greatly inflate its financial reports, EES essentially "purchased" their participation by promising them unrealistic savings, charging low prices that EES knew were likely to result in a loss to EES, and expending millions of dollars in the short term to buy energy-efficient equipment, expenditures that it knew it was highly unlikely to recover, and certainly not to make a profit on. Moreover, as is typical in a Ponzi scheme, the monster created required increasing funds to sustain it. EES had to attract more and more clients by more and more such fraudulent deals to keep up its artificially inflated financial reports and to make the business appear successful so that investors would continue to believe the contracts were making money and pour their money into Enron stock. The complaint discusses the kinds of money-losing contracts EES made with major customers, including Starwood Properties, Chase Bank, Eli Lilly, Owens Corning, Simon Properties and the Archdiocese of Chicago.

Significantly, the complaint quotes EES employees, whose comments indicate that "everybody knew" what was going on in EES. Glenn Dickson, who was the director of asset operations at EES during the Class Period, stated that upfront payments by EES "were not unusual," and "It was fairly common on the really big deals to pay the customer, to lose money, in effect on the contract, whether you were paying the customer or losing money you were charging less than it really cost." Complaint at 307, ¶ 542. Dickson also identified "a form of accounting in which the company counted future projected earnings as current income" as the factor which made the scheme work; "It was huge amounts of money that covered up those cash outlays." *Id.* Furthermore, as discussed in #1194, at 127 n.62, in August 2001 an EES manager wrote a letter to Enron's Board with the following comments:

> One can only surmise that the removal of Jeff Skilling was an action taken by the board to correct the wrongdoings of the various management teams at Enron . . . (i.e., EES's management's . . . hiding losses/SEC violations).
> . . . [I]t became obvious that EES had been doing deals for 2 years and was losing money on almost all deals they had booked.
> . . . [I]t will add up to over $500MM that EES is losing and trying to hide in Wholesale. Rumor on the 7th floor is that it is closer to $1 Billion . . . [T]hey decided . . . to hide the $500MM in losses that EES was experiencing. . . . EES has knowingly misrepresented EES['s] earnings. This is common knowledge among all the EES employees, and is actually joked about. But it should be taken seriously.

If everybody knew, including the Board, there is a strong inference that EES' President, Lou Pai, while collecting his huge bonuses,

based on the falsely inflated financial results and selling all of his Enron stock within the Class Period, also knew. According to the complaint, Pai received bonus payments of millions of dollars in 1997, 1998, 1999, and 2000. Complaint at 65, ¶ 83(j).

In sum, the Court finds that Lead Plaintiff has stated a claim against Pai under § 10(b), §20(a), and § 20A.

Richard B. Buy

Buy is sued under §§ 10(b), 20(a), and 20A of the Exchange Act and under the TSA.

As with its other TSA claims, Lead Plaintiff must amend its pleadings as to Buy or inform the Court that it no longer wishes to pursue its TSA claim against Buy.

The complaint at 64, ¶83(i), identifies Buy as the Executive Vice President and Chief Risk Officer of Enron since 6/99; Senior Vice President and Chief Risk Officer from 3/99 until 7/99; and Management Director and Chief Risk Officer of ECT from 1/98 until 3/99. It alleges that he sold 140,234 shares of Enron stock, or 81.28% of his holdings, during the Class Period for $10,656,595, allegedly while in possession of nonpublic, confidential information regarding Enron, and that he received substantial bonuses of over $1.6 million in 1997, 1998, 1999, and 2000. *Id.* at 64, ¶83(i); at 87, ¶84; at 259, ¶402. He sat on Enron's Management Committee in 1998 and its Executive Committee in 1999. Complaint at 92, 93.

The record reflects that at a meeting of the Finance Committee on October 11, 1999, of the Board of Directors on October 11, 1999, and of the Finance Committee on October 6, 2000 (Ex. 23, Ex. 24 at 17, and Ex. 27 at 2 to #858, Appendix in Support of Plaintiffs' Opposition to Motions to Dismiss), when the conflict of interest of Andrew Fastow arising from his roles at Enron and the LJM partnerships was waived, the board and committee members were told that, as one of the major safeguards checking Fastow's power, all transactions involving Fastow, Enron and the LJM partnerships would have to be reviewed and approved by Chief Accounting Officer Causey and Chief Risk Officer Buy. The story of Enron's collapse painted by the complaint strongly implies that neither met his obligation despite being very aware of the dangers of that waiver.

In its response (#858 at 43-44) to Buy's motion to dismiss, Lead Plaintiff relies on the Powers Report, which has not been made part of the record in this litigation, although the Court has obtained a copy of it from Lead Plaintiff. Lead Plaintiff makes a number of new allegations against Buy not contained within the complaint. Specifically Lead Plaintiff emphasizes that despite his designated position as "Senor Risk Officer" and despite the obvious dangers arising from the waiver of Fastow's conflict of interest contrary to Enron's Code of Conduct, Buy failed in his obligation to oversee and monitor Fastow's transactions, which would necessarily have involved Buy in the core deals at the heart of the

alleged Ponzi scheme. Powers Report at 22.[5]

As another example, Lead Plaintiff points out that the head of Enron's Research Group personally advised Buy that the pricing of the Rhythms NetConnection put-option strategy and credit capacity of Swap Sub were dubious and advised against the transaction because it (1) involved an obvious conflict of interest since Fastow was personally involved in LJM1; (2) the pay out was detrimental to Enron because LJM1 was to receive its return first before any distribution to Enron; and (3) the financial structure with respect to credit capacity was unstable because the SPE was capitalized mainly by Enron's own stock. Powers Report at 84-85.

Lead Plaintiff additionally charges that *inter alia* Buy formally approved Raptor I and executed the LJM2 Approval Sheet between May 22 and June 12, 2000, several weeks after the deal had actually been consummated, on April 18, 2000. Powers Report at 105. That Approval Sheet identified Kopper, a Managing Director of

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[5] The Powers Report at 22 states:

> Buy was and is Enron's Senior Risk Officer. The Board of Directors also charged him with a substantial role in the oversight of Enron's relationship with the LJM partnerships. He was to review and approve all transactions between them. The evidence we have examined suggests that he did not implement a procedure for identifying all LJM1 or LJM2 transactions. More importantly, he apparently saw his role as more narrow that the Board had reason to believe, and did not act affirmatively to carry out (or ensure that others carried out) a careful review of the economic terms of all transactions between Enron and LJM.

Enron, as the negotiator for LJM2. *Id.* Furthermore Lead Plaintiff claims that although Causey, Buy and others were aware that the deficit owed by the Raptor vehicles to Enron in February 2001 was $175 million more than the Raptors had the capacity to pay, and by March 2000, approximately $500 million more than they had the capacity to pay, Causey and Buy did not inform the Committees or the Board of this fact. Nor did they tell the Committees or Board that this deficit would necessitate a charge against Enron's earnings or that the Raptor vehicles would require restructuring, which took place on March 26, 2001 with the transfer of about $800 million of Enron stock contracts, also undisclosed to the Board. Powers Report at 160.

In the interests of justice the Court grants leave to Lead Plaintiff to amend/supplement its complaint to add these allegations. Lead Plaintiff shall also file a copy of the Powers Report to make it part of this record.

Based on all the allegations discussed *supra*, provided that Lead Plaintiff does amend/supplement, the Court finds that Lead Plaintiff has stated claims against Causey under § 10(b) for selling most of his Enron stock while in possession of nonpublic, confidential information regarding Enron in breach of his fiduciary duty to disclose and for engaging in an act, practice, or course of business that operated as a fraud or deceit upon investors. Lead Plaintiff has also stated claims against Buy for controlling person

liability under § 20(a), based on his position as Chief Risk officer and membership on key committees combined with his alleged decision not to fulfill or to recklessly disregard the obligations of his job and the board's directive to minimize obvious risks threatening the company because of Fastow's dual role, and under § 20A for insider trading. Thus the Court denies his motion to dismiss.

Joseph M. Hirko

Charging Hirko with violations of § 10(b), §20(a), and § 20A, the complaint identifies Hirko as CEO of EBS at all relevant times, and a member of the Enron Management Committee in 1997 and 1998 and the Executive Committee in 1999. Complaint at 66, ¶83(k); 91-94, ¶88. During the Class Period he sold 473,837 shares of Enron stock (19.87% of his Enron holdings) for proceeds in the amount of $35,168,721, allegedly while in possession of nonpublic, confidential information regarding Enron. *Id.*; at 259, ¶402.

When viewed in their totality, the circumstances surrounding Hirko's involvement in Enron suggest that he was distanced from the daily operations of the company and the alleged Ponzi scheme. Hirko points out that he had been an executive with PGE before it was acquired by Enron in 1997, and that he only became an Enron employee with the acquisition. Moreover, Hirko remained in Oregon and never lived in Houston, where management of the day-to-day operations of Enron took place. Lead Plaintiff has not

controverted this representation. The complaint does not allege that Hirko attended the meetings of the Management Committee in Houston, and the only exhibit in the record of Management Committee minutes, i.e., for a November 5, 1997 meeting (#856, ex. 21), reflects that Hirko was not in attendance. The complaint makes no allegations that Hirko received any bonuses. Nor does the complaint assert that Hirko participated in the preparation of any of Enron's financial statements or accounting decisions. Hirko emphasizes that he was CEO of EBS only "in its very early stages,"[6] because Kenneth Rice was named co-CEO in June 1999 and then became the sole CEO in June 2000, when Hirko left EBS and Enron. Moreover, the sale of Hirko's Enron stock, constituting only 19.87%% of his Enron holdings, occurred in the spring of 2000, just prior to his separation from EBS and Enron, and he continued to hold over 80% of his Enron investments. Complaint at 257-59, ¶¶401-402.

Furthermore, as will be discussed with respect to Kenneth Rice, the alleged fraud in Enron's broadband business appears to have blossomed under Rice's control, after Hirko's departure in June from Enron and EBS, starting with the Enron-Blockbuster deal in July 2000. Until then EBS is portrayed in the complaint as an internet business off to a rocky start. Lead Plaintiff has not

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[6] #685 at 2 n.3. Hirko represents that although EBS consummated more than 320 broadwidth transactions during his last year as CEO, i.e., 2000, only 25 of those had been completed when he left at the end of June 2000.

alleged that Hirko make any false or misleading statements; indeed all the challenged statements about EBS relate to Rice, who had already begun taking over the reins in 1999 and became sole CEO of EBS in June 2000.

After carefully reviewing the pleadings, the Court finds that Lead Plaintiff has not stated a claim under any of the three provisions of the Exchange Act against Hirko and therefore Hirko's motion to dismiss should be granted.

Kenneth D. Rice

Rice was Chairman and CEO of Enron Capital & Trade ("ECT")-North America from March 1997 until June 1999, and became Chairman and sole CEO of EBS in June 2000. Complaint at 63, ¶83(h). He served on Enron's Management Committee from 1997 until 2000. The complaint states that while he was in possession of adverse confidential information about Enron, during the Class Period Rice divested himself of 55.10% of his Enron securities holdings, i.e., he sold 1,234,009 shares of Enron stock for $76,825,145 and transferred 27,847 shares valued at $2,222,691 to the corporation to pay the exercise price of options he was exercising plus tax withholding, so that most of the sale proceeds went directly to him. *Id.* at 63, ¶83(h); at 259, ¶402. Furthermore, Rice received notable bonus payments of $6.4 million in 1997, 1998, 1999, and 2000, based on the company's allegedly false financial reports and the success of Enron stock in hitting performance targets. *Id.*

The factors the Court has considered in finding that Lead Plaintiff has stated a claim under § 10(b) against those Insider Defendants who intimately managed the day-to-day operations of Enron and, in Rice's case, EBS, and who sat on the important Management Committee which approved most, if not all, significant actions, following strikingly repetitive patterns and applying high-risk accounting, often at critical reporting times when Enron was threatened with not "making its numbers," apply to Rice also. He, too, is charged with selling stock after being made aware of this confidential nonpublic information of fraudulent transactions without disclosure of that information to the shareholders. Furthermore, the allegations against Rice include substantial involvement in and awareness of the alleged fraud at EBS and false and misleading statements to the public.

The Court observes that the complaint's portrayal of EBS, especially the joint venture with Blockbuster Video-On-Demand and Project Braveheart, constituted one of the more egregious deceptive contrivances in the Ponzi scheme and that, as with EES, numerous EBS employees were aware of the scam and quite vocal about it For instance, the complaint states that a group of managers engaged in "a coup attempt" in 2001, complaining of CEO Rice and Chief Operating Officer ("COO") Hannon to Jeffrey Skilling in an effort to have Rice and Hannon removed. *See* #1194 at 127-30 & nn.63 & 64; 131-32 and n.66; 177-80 & n.86; 245; *see also* complaint at 197-202,

¶300(h)-(o); at 226-30, ¶339(h)-(o).[7] The complaint alleges at both 199, ¶300(j)(iii) and at 226, ¶339(j)(iii),

> (iii) The situation in EBS was so desperate by Spring 01 that there was a coup attempt by several managers who reported to CEO Rice and COO Hannon and wanted them moved out of EBS. The managing directors met with Skilling and informed him that EBS was in extremely dire straits-there was ***"no way to win,"*** EBS ***"had no income,"*** and the ***"cash-burn rate was too high."*** They showed Skilling actual EBS performance numbers. Rejecting their request, Skilling neither replaced Rice and Hannon nor did he make any changes, other than having the managing director also now report to him directly to keep him updated on the disaster in EBS; and
> (iv) Despite concrete evidence of EBS's failed operations, EBS CEO Rice publicly stated that broadband's assets had an estimated value of $36 billion. A high-ranking former EBS manager-one of the very first broadband employees-responded: ***"I don't know what metric he was looking at. We were well into the business by then and in the process of flopping.***

As another example of the general knowledge of the fraud ongoing at EBS in 2000, the complaint recites,

> EBS executives were desperate because they were not generating any revenue, which was the catalyst behind the deal with Blockbuster. But an EBS director of engineering stated, ***"Flat out, we didn't have the technology to do it, and we didn't have the expertise. It was a deal EBS executives entered into with no***

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[7] After the recent indictment of two executives of EBS, Kevin Howard and Michael Krautz, for their roles in the Blockbuster/Project Braveheart transaction, the SEC filed a civil action against them, alleging *inter alia*, "Project Braveheart was a sham from its inception. The transaction had no economic substance and was created solely for the purpose of generating earnings. The joint venture partner was an entity that never intended to participate as a partner, and its equity was not at risk because Enron guaranteed the entity a short term take-out at a specified rate of return." *United States Securities and Exchange Commission v. Kevin A. Howard and Michael W. Krautz*, H-03-CV-905, Instrument #1 at 2.

> ***capacity to do it."*** A former EBS employee, who worked directly on the Blockbuster deal in multiple capacities, including product development, financial analysis and content distribution, stated, ***"[T]he Blockbuster deal was a fraud, and Enron's top management knew it.*** Employees working on the Blockbuster VOD deal were told time and again, after they stressed the deal's lack of economic sense, to ***"just drink more Enron Kool-Aid."***

Complaint at 201-02, ¶300(o). The complaint also asserts that "in 6/00, Rice personally tried to recruit two EBS engineers, who had left Enron out of frustration over EBS problems, by telling them that they were essential because ***"we [Enron] can't deliver the Blockbuster deal."*** The Blockbuster deal had no economic substance at the time . . . . Complaint at 202, ¶300(o).

According to the complaint, Project Braveheart, itself, allegedly followed the typical pattern, starting with Chewco, of Enron-controlled entities and fraudulent transactions constituting deceptive devices or contrivances that were repeatedly presented to the Management Committee for approval. After the Enron-Blockbuster deal was announced with great fanfare in July 2000, it failed within a very short time to show the profits that Enron officials kept projecting without any basis, since Enron did not have the technology nor the legal rights to deliver the product. The Project Braveheart venture then established an off-the-books partnership, called Braveheart, in which the 3% interest required for a legal unconsolidated SPE was purportedly owned by independent outsiders, but which in reality was secretly controlled by Enron. Investors were promised, indeed guaranteed, shares in Braveheart's

future earnings, while Enron, employing sophisticated financial hijinks including mark-to-market accounting, transferred its own debt to the partnership, but recorded as its own profits the venture's sham revenue, with Arthur Andersen's approval, all of which Lead Plaintiff alleges astonished EBS employees. Enron announced the termination of the Blockbuster deal in March 2001, only nine months after it was begun. Yet Enron's write-off in the fall of 2001 included $111 million that it had previously claimed as "profits" during the Project Braveheart venture.

The complaint alleges that Rice was aware of the condition of the company and was involved in other allegedly fraudulent transactions. The complaint represents that even by October 1999, EIN ("the core of the Enron Broadband Operating System") was known by Rice to be "a disastrous failure." Complaint at 153, ¶214(i). In addition, Rice as CEO presided over the alleged sham dark-fiber swaps and fraudulent accounting that were employed by EBS to inflate EBS' revenues. Complaint at 134, ¶173; at 154, ¶ 214(j) and (k). The complaint also asserts that Rice, along with Causey, was involved in negotiating the sham sale in mid-May 2000, from Enron (EBS) to Fastow's LJM2, of certain telecommunications assets, known as Backbone, i.e., dark fiber that was not certified as usable. Lead Plaintiff insists that Rice knew that the transaction was not between two independent parties at arm's length and that no legitimate buyer could be found to purchase these assets.

Moreover, the sale to LJM2 was made with the agreement that EBS would re-market the dark fiber after LJM2 purchased it and that LJM2 would enjoy an 18% return on the resale. According to the complaint, Enron recognized $54 million from the deal, but Fastow was angry when he learned the dark fiber was not certified and that it might take a year to get it certified. Complaint at 286-87, ¶475.

Furthermore several allegedly false and misleading statements regarding EES and EBS to the market are attributed to Rice. Complaint at 134, ¶173; 206-07, ¶309; at 210-11, ¶317.

Thus the Court finds that Lead Plaintiff has stated a claim against Rice for insider trading in breach of his fiduciary duty of disclosure, for false and misleading statements to deceive investors, and for deceptive acts or practices in the course of business that would operate as a fraud on investors, under § 10(b) and § 20A. In light of Rice's executive position and his role on the Management Committee, Lead Plaintiff has also stated a claim for controlling person liability under § 20(a) against Rice.

Richard A. Causey

Causey is sued under §§ 10(b), 20(a), and 20A of the Exchange Act, § 11 of the 1933 Act, and the TSA.

As noted previously, all TSA claims must be repeaded.

Causey, Executive Vice President and Chief Accounting Officer ("CAO") of Enron, allegedly sold 208,940 shares of Enron stock, or

72.98% of his holdings during the Class Period for proceeds of $13,386,896, while Causey was in possession of adverse, undisclosed information about Enron, to be discussed below. Complaint at 59, ¶83(d); at 257-60, ¶¶401-02. He also received bonuses of over $1.5 million in 1997, 1998, 1999, and 2000 that were based on the purported false financial reports filed by the company and on the success of the company's stock in hitting performance targets. *Id.* at 59, ¶83(d). He sat on the Management Committee in 1997, 1998, 1999, and 2000, and approved various challenged transactions among Enron and Enron-controlled partnerships and SPES, with which he is further linked. Complaint at 91-94, ¶88. Thus Causey clearly had the power to control Enron and Enron policy.

The Court takes judicial notice of the fact, reported in numerous newspaper and magazine articles, that Causey is an accountant, that he had joined Arthur Andersen in the 1980's and worked in Houston auditing the Enron account, and that Causey was hired by Jeffrey Skilling, then head of the company's trading and finance unit, to work for Enron in 1991. *See, e.g.*, David Barboza, "U.S. Hints Ex-Enron Accounting Chief Had Role in Fraud," Business Section, *N.Y. Times* (Oct. 4, 2002).[8]

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[8] Although some of the article's allegations are not appropriate for judicial notice, the Court observes that according to Barboza, Causey "was said to have specialized in off-balance-sheet deals, which are at the heart of the Enron scandal." *Id.* Barboza reports that at Enron, Causey worked for some of the first off-balance-sheet partnerships, including JEDI. *Id.* Since the board was told that Causey, along with Buy, would

As noted under the Court's discussion of Richard Buy, when the board and committees three times waived the conflict of interest of Fastow in serving both Enron and the LJM partnerships contrary to Enron's own Code of Conduct, the board and committee members were told that as one of the major safeguards checking Fastow's power, all transactions involving Fastow, Enron and the LJM partnerships would have to be reviewed and approved by Chief Accounting Officer Causey and Chief Risk Officer Buy. The story of Enron's collapse painted by the complaint strongly implies that neither met that obligations despite being very aware of the dangers of that waiver.[9]

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oversee Enron's relationships with the LJM partnerships, Causey would appear to be fully capable of recognizing the manner and purpose for which these related-party transactions were utilized.

[9] This Court observes that the indictment against Andrew S. Fastow makes a couple of allegations against Causey, identified only by his position as Enron's CAO. The first, reiterating a claim in this civil case, states that Causey was involved in management's allegedly false representations to Enron's Board of Directors and second, that Causey had a secret deal with Fastow that served to protect and enrich LJM's investors, including Fastow, at Enron's expense:

> 21. FASTOW and others made various false representations to Enron's Board of Directors (the "Board") to obtain its approval for FASTOW's participation in LJM. Specifically, the Board was assured that: (a) Enron's Chief Accounting Officer ("CAO") and Chief Risk Officer would review transactions with LJM to ensure their fairness to Enron; (b) the Board would be informed of all Enron transactions with LJM; (c) the purpose of LJM was to buy assets from Enron; and (d) although FASTOW would be compensated by LJM, he would not profit from any appreciation in the value of Enron stock held by LJM or its affiliates.

The complaint's allegation of the practice of snowballing (accumulation of deferred expenses with few write-offs) at Enron International, is also related to Causey:

> Costs for South American projects involving oil and gas reserves, pipelines, and a plant designed to convert ore into another form of energy, and projects in China, among others, were "***snowballing***" quickly-the cash burn rate was as much as ***one million dollars a month***-but not being expensed. As former executive explained, quarter after quarter, year after year, Enron International "***got***

> 22. In fact, as FASTOW knew, far from reviewing transactions with LJM to ensure their fairness to Enron, Enron's CAO and others had an undisclosed agreement with FASTOW that ensured that, over time, LJM would not lose money in its dealings with Enron.

United States v. Andrew S. Fastow, H-02-CR-665-01, Instrument #1 at 8, ¶¶22-23.

The indictment further alleges that Causey was involved in a secret side agreement involving Talon, another illegitmate Enron-controlled SPE, funded mainly by a promissory note, Enron stock, and a $30 million investment from LJM, and established to hedge the price of Enron's stock. Specifically the indictment alleges,

> 36. . . . Enron and FASTOW entered into a side agreement whereby Enron guaranteed that it would pay $41 million to LJM before Talon would be allowed to engage in the hedging transactions for which it was created. In exchange, FASTOW allowed Enron to use Talon to manipulate Enron's balance sheet. As a result of this secret side deal, LJM's investment was never truly at risk.
>
> 37. In order to mask the side deal, FASTOW, Enron's CAO, and others devised a scheme to manufacture a $41 million payment from Enron to LJM. To do so, Enron and Talon entered into a "put," that is, a transaction that ostensibly served to hedge Enron against a decline in its own stock value. That "put" option was purchased by Enron for $41 million. The $41 million was paid to Talon and then transferred to LJM on September 7, 2000.

Id. at 12, ¶¶36-37. The *Newby* consolidated complaint at 288, ¶479, discusses the sham put option involving Talon.

> ***pressure from corporate about meeting earnings***," which prohibited write-offs--even when it was clear that the proposed project would never go forward. Consequently, the "***snowball***" grew exponentially--so large that an international accounting officer repeatedly told Enron's CAO Causey that a write-down ***had to be taken because so many proposals were no longer even arguably viable***. But this ran counter to corporate directives. Causey, at ***Skilling's direction, routinely responded that "corporate didn't have room" to take a writeoff because doing so would bring Enron's earnings below expectations.*** By 97, years past when start-up proposal costs should have been written off, ***Enron had deferred a $100-million "snowball"*** on some 75 projects, including those in Central and South America and the Dabhol power plant in India, while the cash-burn rate-virtually all deferred-dwarfed the revenue return.

Complaint at 111, ¶121(f); repeated at 127-28, ¶155(k), and at 318-19, ¶581.

In its response Lead Plaintiff points to the Powers Report's findings, at 21, that Causey "presided over and participated in a series of accounting judgments that, based on the accounting advice we have received, went well beyond the aggressive." As noted, Causey was an accountant who had previously worked at Arthur Andersen. Moreover, citing the Powers Report as its source, Lead Plaintiff's response lists specific actions taken by Causey reflecting his personal and extensive involvement with Fastow in the transactions among the LJM partnerships and related parties used to defraud the public and investors. #856 at 45-46.

Furthermore, the complaint asserts that Causey served with Lai, Pai, and Derrick as officers and/or directors of New Power, and with Glisan and Fastow as officers and/or directors of Atlantic

Water Trust and Egret. Complaint at 85, ¶¶83(hh), (ii), and (jj). Causey was supposed to be overseeing these entities to prevent the kind of fraud for which they were allegedly used. The complaint claims that Causey signed the documentation for transactions involving Enron and Talon, one of the Raptors. Complaint at 288, ¶480. Thus Causey's personal involvement in the entities at the core of the alleged Ponzi scheme was substantial and dubious in light of his obligations to the board and the shareholders and his accounting expertise.

The complaint further alleges that Causey, *inter alia*, signed or reviewed and approved various false and misleading statements, including two registration statements, filed with the SEC, and thereby "made a statement" within the meaning of § 10(b), as well as violated § 11. Complaint at 114, ¶126; at 116-17, ¶134; at 117-19, ¶¶136-141.

Thus the Court finds that Lead Plaintiff has stated a claim against Causey under §§ 10(b), 20(a), and 20A of the Exchange Act and § 11 of the 1933 Act.

Jeffrey McMahon

McMahon was Enron's Chief Financial Officer of Enron Europe from 1994 until 1997; Senior Vice President, Finance and Treasurer from July 1998 through July 1999; and Executive Vice President, Finance and Treasurer since July 1999. Complaint at 71, ¶83(p). He received substantial bonuses of $3.3 million in 1997, 1998, 1999

and 2000. *Id.* He sat on the Management Committee in 1998 and 1999. Complaint at 93-94, ¶88.[10] During the Class Period, he sold 39,630 shares of Enron stock (29.20% of his holdings) for $2,739,226. Complaint at 71, ¶83(p); at 258, ¶401; at 259, ¶402.

In its response to McMahon's motion to dismiss, Lead Plaintiff again turns to the Powers Report at 21 to assert that during the same month McMahon sold this stock, March 2000, McMahon met with

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[10] Lead Plaintiff emphasizes and the complaint twice mentions McMahon relating to general statements made near the close of the Class Period, but these do not appear to the Court to be telling in content or in timing. On November 1, 2001, in a release issued by Enron announcing commitment letters from J.P. Morgan and Salomon Smith Barney to provide $1 billion of secured credit lines, McMahon is quoted as saying, "This is yet another step in our efforts to enhance market and investor confidence. We are moving aggressively to strengthen our balance sheet and maintain our investment credit rating." Complaint at 249-50, ¶ 383. On November 14, 2001, Lay, Whalley, McMahon and Causey held a conference call for analysts at which they stated (individual speakers not distinguished and statements not quoted):

> ***Enron made some very bad investments. Investments such as Azurix, India and Brazil had performed poorly. Because of these investments, Enron became over-leveraged. Enron entered into related-party transactions that produced various conflicts of interest.***
>
> ***Enron's core business was still the best franchise in the industry.***
>
> ***Enron remained optimistic that actions to prevent insolvency substantially answered Enron's credit and liquidity questions. Enron's current transaction levels, while lower than the recent averages, have remained strong.***

Complaint at 251, ¶388.

Skilling because McMahon had "serious concerns about Enron's dealings with the LJM partnerships." The Court notes that, Sherron Watkins' August 2001 letter to Lay, quoted several times in the complaint, asserted *inter alia*,

> ***There is a veil of secrecy around LJM and Raptor. Employees question our accounting propriety consistently and constantly*** . . . .
> a. Jeff McMahon was highly vexed over the inherent conflicts of LJM. ***He complained mightily to Jeff Skilling*** . . . . 3 days later, Skilling offered him the CEO spot at Enron Industrial Markets . . . .

Complaint at 427, ¶850. Such allegations give rise to a strong inference of scienter about both McMahon and Skilling, who apparently instantly demoted the protester.

The Court notes other allegations in the complaint serve to explain McMahon's familiarity with the SPEs and the purported purposes behind their transactions; they also link McMahon to significant acts or practices in the course of Enron's business that operate a fraud on investors and as deceptive devices and contrivances in furtherance of the Ponzi scheme in connection with the sale or purchase of securities. In discussing the ongoing involvement of Credit Suisse First Boston and its banker, Lawrence Nath, in setting up the illicit SPEs to "monetize" assets by moving them off Enron's books to one of these entities, the Court in its memorandum of December 19, 2002 summarized the complaint's allegations about McMahon:

> Nath would go to Houston for a week or two, meet with a group from Enron's treasury and global finance

> departments ("Fastow's field marshals"), including Jeff McMahon or Ben Glisan (successive treasurers of Enron),[11] and create a solution in order to doctor the Enron books. According to the complaint, most of the vehicles created in this manner by Nath shared the same unusual feature: the SPEs held Enron stock to reassure lenders and secure an investment grade rating, but there were set "trigger points," or prices between $83-$19 per share, at which the stock's declining value would require Enron to put more shares into the entity or even force liquidation if Enron's credit rating was downgraded. At that point the debt of the SPEs became recourse to Enron. A knowledgeable banker stated, "Taken in combination, these partnerships clearly posed a material risk for the company." Complaint at 369.

#1194 at 173. *See* complaint at 368-70, ¶¶707-711. The Court takes judicial notice of the widely publicized fact that McMahon also started his career working for Arthur Andersen in Houston after he finished college.

For these reasons and for his purported sale of Enron securities in breach of his fiduciary duty of disclosure, the Court finds that Lead Plaintiff has stated claims against McMahon under § 10(b) and 20A of the Exchange Act. His position as Treasurer, his seat on the Management Committee, his accounting expertise, and his personal knowledge from creating the allegedly fraudulent SPEs demonstrate that he had the power to control Enron's policies and business. Thus the Court finds that Lead Plaintiff has also stated a claim for controlling person liability under § 20(a).

James V. Derrick, Jr.

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[11] Glisan became Treasurer of Enron in May 2000, after McMahon was demoted.

Derrick is sued under §§ 10(b), 20(a), and 20A of the Exchange Act.

Derrick was the Enron's Senior Vice President and General Counsel until July 1999, when he became Executive Vice President and General Counsel. Complaint at 60, ¶83(e). He received bonuses of over $1.2 million in 1997, 1998, 1999, and 2000, based on Enron's allegedly false financial reports and the performance targets reached by Enron stock. *Id.* Derrick sold 230,660 shares of Enron stock (12.9% of his holdings) during the Class Period for proceeds of $12,563,928. *Id.*; at 259, ¶402. Derrick sat on the Management Committee in 1997, 1998, 1999, and 2000, and on the Executive Committee in 1999. Complaint at 91-94, ¶88.

Lead Plaintiff asserts that Derrick was also an officer or director of New Power and "particularly aware of the fraudulent business occurring" between Enron and New Power. Complaint at 85, ¶¶83(hh), 488. Nevertheless, like Lead Plaintiff's response, the complaint does not provide any specific facts about Derrick's knowledge or role at, nor any facts that would create a strong inference of scienter for him with respect to his involvement in, the New Power transaction.

There are also no allegations of false statements against Derrick. Nor, unlike with most of the other insiders, does the complaint make any specific allegations showing that he was involved in any way in the day-to-day business operations of Enron

or with the individuals alleged to have been at the heart of the Ponzi scheme and violating § 10(b).

In its response to Derrick's motion to dismiss, Lead Plaintiff cites not its complaint, which is silent about Derrick's involvement in Vinson & Elkins' 2001 investigation of Enron, but the Powers Report at 173 to argue that after Sherron Watkins' letter to Lay, which Lay shared with Derrick, despite "a downside to retaining V&E because it had been involved in the Raptor and other LJM transactions," Derrick recommended that Vinson & Elkins perform the first investigation on the grounds that the law firm was familiar with Enron and LJM matters, it would be able to conduct the investigation quickly, and it would be able to follow Watkins' roadmap. The report also states that "Derrick and V&E agreed that V&E's review would not include questioning the accounting treatment and advice from Andersen, or a detailed review of individual LJM transactions." *Id.* These facts could be interpreted as constituting an act of deception and concealment if the complaint had adequately pleaded scienter as to Derrick, but it has not. As the Court has previously indicated, the internally managed "investigation," which was not intended for public disclosure and was not disclosed until after the Class Period, did not, by itself, constitute a violation of § 10(b).

Lead Plaintiff also cites the Powers Report at 183 for the proposition that Derrick "helped V&E prepare deceptive related-

party disclosures and he gave substantial advice and reviewed disclosures made in Enron's financial statements." Yet the Court finds that, when reviewed in the context provided by pages 182-83 of the Powers Report, Plaintiff has skewed the Powers report to support its contention Derrick participated in the fraud with Vinson & Elkins throughout the Class Period and then tried to conceal it by having the firm perform a whitewash investigation. In context the Powers Report states:

> While accountants took the lead in preparing the financial statement footnote disclosures, lawyers played a more central role in preparing the proxy statements, including the disclosures of the related-party transactions. This process was organized by Associate General Counsel Rogers and lawyers working for him, with substantial advice from Vinson & Elkins. James Derrick, Enron's General Counsel, reviewed the final drafts to look for obvious errors, but otherwise had little involvement with the related party proxy statement disclosures. He said that he relied on his staff, Vinson & Elkins and Andersen to make sure the disclosures were correct and complied with the rules. Enron's in-house counsel say they relied on advice from Vinson & Elkins in deciding whether the proposed disclosures were adequate, particularly with respect to related-party transactions.

Lead Plaintiff has not alleged any specific facts that would demonstrate that Derrick was trained in accounting or personally involved in preparing the statements. From the circumstances alleged, it appears that he relied on Vinson & Elkins' expertise.

Finally Lead Plaintiff points to ¶848 of the complaint at 424-25. It quotes a paragraph in a proxy filed by Enron on May 2, 2002, ¶848 disclosing related-party matters, which the complaint alleges is "almost identical to the previous year's." The

complaint then generally states, "The decision to disclose nothing more than what was stated above in both the 00 and 01 Proxies was a consensus between [*sic*] Vinson & Elkins, Fastow, Jordan Mintz, Derrick and others at Enron and was discussed in a memo written by Mintz." *Id.* No specifics are provided about each's role, or how, when, where, why and what was not disclosed. Clearly such pleading will not satisfy the PSLRA.

Thus the only allegation that might serve to support liability under § 10(b) was his seat on the Management Committee, but without the added knowledge from day-to-day, personal participation in the business operations of Enron that his Co-Defendants brought to the table, and without any allegations of a background in accounting. After reviewing all the circumstances alleged in the pleadings, the Court finds that Lead Plaintiff has failed to state a claim against Derrick under the Exchange Act.

Kevin P. Hannon

Hannon is sued under §§10(b), 20(a), and 20A of the Exchange Act.

The complaint represents that Hannon, after serving as Enron's president of trading and commodities, was employed as Operating Officer of EBS from January 2000 until he resigned in August 2001 and "participated in the bandwith trading by which Enron misstated

its financial results."[12] Complaint at 75, ¶83(t).[13] According to the complaint, "At Hannon's request, he was not considered an officer of Enron specifically so he could avoid reporting his stock sales," but that he "sold shares of his Enron Stock for millions in illegal insider trading proceeds" as well as "call options[14] on Enron stock prior to 5/1/01 such that he would profit so long as Enron stock dropped below $70 per share by 1/19/02." Complaint at 75, ¶ 83(t). The complaint also identifies Hannon as serving in 1997, 1998, 1999 and 2000 on the critical Management Committee, to which all significant Enron business transactions in noticeable patterns, utilizing acknowledged high-risk accounting frequently at critical reporting times when Enron was threatened with not "making its numbers," were presented. Complaint at 91-94, ¶88.

Along with these alleged facts, the Court finds that many of the allegations brought against Rice and Hannon together suffice to state claims against Hannon under § 10(b), § 20(a), and § 20A. See pages 20 *et seq.* of this memorandum and order.

Kenneth L. Lay

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[12] Hannon states that he worked at EBS only until June 2001.

[13] Hannon also allegedly "was involved with, and made positive public statements about Enron-Online," but the complaint never mentions Enron-Online again nor discusses any public statements about it. Complaint at 75, ¶ 83(t).

[14] The complaint at 75, n.4, defines "call option" in this context: "A call option entitles a buyer the right to force Hannon to sell, at a specified exercise price, such that Hannon would (and did) profit if the stock price declined below the exercise price."

Lay is sued under §§ 10(b), 20(a), and 20A of the Exchange Act, §§ 11 and 15 of the 1933 Act, and under the TSA. As previously indicated, Lead Plaintiff must replead the last claim.

Lay was Enron's director, Chairman of the Board of Directors, and Chief Executive Officer from 1986 through February 2001, and again from August 2001, after Skilling resigned, until the end of the Class Period, and thus had lengthy familiarity with and access to business operations at Enron. Complaint at 55, ¶83(a). Lay received notable bonuses of $18.1 million for 1997, 1998, 1999 and 2000, based on Enron's allegedly fraudulent financial reports and the stock's success in reaching performance targets. *Id.* Significantly, from 1995-2002 he was not only a member of the Board's Executive Committee, which met frequently to oversee and review Enron's business and which could exercise all of the powers of the Board, but also, from 1997-2000, a member of the key Management Committee, which conducted the day-to-day business of Enron, repeatedly waived Fastow's conflicts of interest, and approved all significant business transactions, including those with the LJM partnerships and the illicit SPEs at the core of the alleged Ponzi scheme. These key transactions followed noticeable patterns with acknowledged high-risk accounting, were effected frequently at critical reporting times when Enron was threatened with not "making its numbers," and constituted waving red flags of the alleged fraud, of which any continuous committee member would

have had to have been aware or toward which he would have had to exhibit reckless disregard in light of the pervasiveness, persistence, and repetitive nature of the alleged wrongdoing throughout Enron, all for the purpose of manufacturing positive financial statements to deceive investors and creditors and enriching to an extraordinary degree the very people running the corporation and sitting on the Committee. Complaint at 88, ¶85(c); at 91, ¶88. Furthermore, according to the complaint, during the Class Period Lay divested himself of 54.85% of his Enron holdings, selling 4,002,259 shares of Enron stock for $184,494,426 and transferring 1,456,421 shares of his Enron stock, valued at $76,305,838, to the company to pay the exercise price of options he was exercising and the related tax withholding so that most of the proceeds from his sale of stock went directly to him, allegedly while in possession of adverse confidential information about the company in violation of his fiduciary duty to the shareholders. Complaint at 55-56, ¶83(a); at 257, ¶401; at 259, ¶402. Moreover, Lead Plaintiff has alleged that in light of the enormous salary, huge bonuses, and perks of a lavish lifestyle that Lay received as head of Enron and the enormity and pervasiveness of the alleged fraud, which was again and again openly the butt of complaints and jokes among so many employees before and during the Class Period, including openly at the company's 1997 farewell party for former Enron President Rich Kinder or the 2000 Christmas party, at the

very minimum Lay recklessly disregarded that the corporation was being magically transmuted by deceptive devices and contrivances into a money tree for corporate insiders and Enron's secondary actors to shake for personal enrichment, at the expense of the corporation and its investors.

Lead Plaintiff's response to Lay's motion to dismiss cites the Powers Report at 19, which criticizes Enron's management, in particular Lay, Skilling, Causey, and Buy, for failing "to carry out its substantive responsibility for ensuring that the transactions were fair to Enron" and "for implementing a system of oversight and controls over the transactions with the LJM partnerships." The Powers Report states about Lay,

> For much of the period in question, Lay was the Chief Executive Officer of Enron and, in effect, the captain of the ship. As CEO, he had the ultimate responsibility for taking reasonable steps to ensure that the officers reporting to him performed their oversight duties properly. He does not appear to have directed their attention, or his own, to the oversight of the LJM partnerships. Ultimately, a large measure of the responsibility rests with the CEO.
>
> Lay approved the arrangements under which Enron permitted Fastow to engage in related-party transactions with Enron and authorized the Rhythms transaction and three of the Raptor vehicles. He bears significant responsibility for those flawed decisions, as well as for Enron's failure to implement sufficiently rigorous procedural controls to prevent the abuses that flowed from this inherent conflict of interest.

Powers Report at 19-20. Nevertheless, the Report further notes, "In connection with the LJM transactions, the evidence we have examined suggests that Lay functioned almost entirely as a

Director, and less as a member of Management. It appears that both he and Skilling agreed, and the Board understood, that Skilling was the senior member of Management responsible for the LJM relationship." *Id.* at 20.

As alleged primary violations of § 10(b) and Rule 10b-5, either by employing a device or scheme to defraud or engaging in an act or practice or course of business that defrauded investors in the purchase or sale of securities, in addition to Lay's failure, knowingly or with reckless disregard, to monitor the obvious dangers of Fastow's conflict of interest, which Lay had voted to waive, along with the creation of numerous Enron-controlled but unconsolidated entities and the deceptive transactions among them, and the documented trading of his Enron stock in breach of his fiduciary duty of disclosure to Enron shareholders, the complaint also asserts that Lay, Skilling and Fastow, with Barclays Bank, formed Chewco to deceive others into believing Chewco was an independent entity purchasing an interest in JEDI.

The complaint sets out numerous, prominent instances where Lay allegedly made untrue or misleading statements of material fact in violation of § 10b, which the Court does not consider it necessary to list.[15] These statements included signing allegedly misleading

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[15] Certainly one of the most publicized occurred on September 26, 2001, after he had received Sherron Watkins' letter and after he had requested Vinson & Elkins to perform the investigation of her allegations of serious accounting improprieties despite her explicit warning to the contrary and

financial statements and registration statements, which also provide the basis for Lead Plaintiff's § 11 claims against Lay.

Thus, the Court finds that Lead Plaintiff has stated a claim against Lay under § 10(b) and 20 A of the Exchange Act and § 11 of the Securities Act of 1933. Moreover the complaint clearly alleges that Lay had the power to control Enron's business and policies for Lead Plaintiff's claim under § 20(a)of the Exchange Act and §15 of the 1933 Act.

Jeffrey K. Skilling

Skilling is sued under §§ 10(b), 20(a), and 20A of the Exchange Act, §§ 11 and 15 of the 1933 Act, and the TSA. The last claim must be repled.

Skilling joined Enron in 1990, became a director and President and Chief Operating Officer from January 1, 1997 until February 12, 2001, when he became CEO of Enron for seven months before he suddenly resigned on August 14, 2001, the first signal of what became the rapid implosion of Enron. The complaint asserts that while he was in possession of adverse, nonpublic information about Enron, he sold 1,307,678 shares of his Enron stock (42.47% of his holdings) for $70,687,199, and transferred another 2,063,625 shares, valued at $114,220,286 to Enron to pay the cost of options

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despite the obvious conflict, when Lay reassured Enron workers that Enron's financial reports were legal and proper. In November Enron restated nearly $600 million in previously reported profits and in December, filed for bankruptcy.

he was exercising and related tax withholding. Complaint at 57, ¶83(b); at 258, ¶401; at 259, ¶402. Furthermore, Skilling received significant bonus payments of $13.2 million in 1997, 1998, 1999, and 2000, based on Enron's alleged false financial reports and the stock's success in hitting performance targets. *Id.* Skilling served on the Executive Committee from 1998-2001 and the Management Committee from 1997-2000. Complaint at 89-94, ¶¶86-88.

In addition to these allegations, and others already discussed in this memorandum and order raising a strong inference of scienter,[16] there are many others in the complaint that reflect Skilling's knowing endorsement of deception and misleading financial reports. For instance, he allegedly directed management to support the practice snowballing and rejected requested writeoffs, and he wanted Enron to book all anticipated revenue immediately through an abusive practice of mark-to-market accounting to inflate Enron's financial reports. Complaint at 111,

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[16] These allegations include Skilling's failure to meet his obligations to oversee the LJM transactions and to ensure that they were fair to Enron, and his role as "the senior member of management responsible for the LJM relationship," his decision not to act in light of the EBS managers' attempted coup in March 2001 and complaints to Skilling about Rice, Hannon and EBS' dire financial condition, Skilling's support of snowballing and refusal to allow write-offs because they would prevent Enron from meeting Wall Street's expectations, and McMahon's discussions in March 2000 with Skilling about McMahon's "serious concerns" regarding the LJM partnership. The Court notes that Sherron Watkins' letter to Lay also reported that ***"Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM."*** Complaint at 140-50 n.75,

¶121(f); at 465, ¶939. The complaint asserts that Skilling was regularly apprized of not only the manipulated financial results created by treating transfers of assets to SPEs as sales providing revenue while concealing debt, but also of their failure to prevent a decline in assets, by means of a daily 2-3 page report detailing the positions of the company's assets that was sent to top management, including Skilling. Indeed, as this Court noted in #1194, according to the complaint, even to the end he lied to shore up Enron's sham facade to the public:

> According to the complaint, on July 13, 2001, Jeffrey Skilling told Kenneth Lay that he was going to quit because he knew that the Enron house of cards was crumbling. They and other top Enron officials made up a story that Skilling was resigning for personal reasons to hide the true reason and limit damage to the price of Enron's stock. On August 14, 2001, Fastow, Skilling and other top executives and bankers announced that Skilling, who had only become CEO a few months earlier, was resigning for personal reasons, that his departure did not raise "any accounting or business issues of any kind," that Enron's financial state "had never been stronger" and its "future had never been brighter," that there was "nothing to disclose," that Enron's "numbers look good," that there were "no problems" or "accounting issues," and that the Enron "machine was in top shape and continues to roll on--Enron's the best of the best."

#1194 at 1148.

Lead Plaintiff's response to Skilling's motion to dismiss cites to the Powers Report for allegations of Skilling's direct involvement in the alleged Ponzi scheme's deceptive devices and contrivances: at 20-21 (Skilling supported the Board's waiver of Fastow's conflict of interest; Skilling was directly responsible

for, but determined not to fulfill his obligation to, ensuring that those he supervised performed their oversight duties and that the internal controls established by the Board, especially involving related-party transactions with Fastow, were effectuated); at 46 (involvement in presentation to the Board of the Chewco/JEDI financial arrangements); at 79 (on June 18, 1999 Fastow presented for Lay's and Skilling's approval, prior to submitting the proposal to the Board, a proposal to Lay and Skilling for use of LJM1 and Swap Sub, controlled by Fastow, to enter into a swap with Enron to hedge Enron's position in Rhythms); at 82 n.29 (the Board appointed Lay and Skilling "as a Committee of the Board . . . to determine if the consideration received by the Company is sufficient in the event of a change in the terms of such transaction"); at 99-100 (in 1999 Skilling initiated planning of a mechanism to create what became on April 18, 2000 Enron-controlled Raptor I (a/k/a Talon), with investments marked to market, to provide Enron with a sham hedge against volatility for a portion of its merchant investment portfolio); at 112 (continuing involvement in Raptors); at 113 n.54 (signed the LJM2 Approval Sheet for Raptor IV in March 2001, six months after the deal had closed and the Board had approved the transaction); at 121 (according to senior Enron employees, Skilling was fully informed about the Raptors' insufficient credit capacity); and at 182 (Skilling stated that he consistently reviewed disclosures of related-party transactions).

As is the case with Lay, the complaint identifies numerous allegedly false and misleading statements made by Skilling, as well as financial and registration statements that he signed, which the Court does not find it necessary to list. These provide a basis for Lead Plaintiff's claims against Skilling under § 10(b) and §11. Skilling's alleged trading in violation of his duty to disclose also constitutes a violation of § 11. Given his positions and power to control, the Court further finds that Lead Plaintiff has stated claims for controlling person liability under § 20(a) and § 15. Thus the Court finds that Lead Plaintiff has stated claims under these provisions against Skilling.

Accordingly for the reasons stated *supra*, the Court

ORDERS that Lead Plaintiff shall supplement or amend its complaint as indicated in this and prior orders and shall file a copy of the Powers Report within twenty days of entry of this order or inform the Court of any claims it no longer wishes to pursue against any and all Defendants. Conditioned upon that amendment/supplementation, the Court further

ORDERS that

(1) Ken L. Harrison's motion to dismiss (#621) is DENIED;

(2) Lou Pai's motion to dismiss(#624) is DENIED;

(3) Richard B. Buy's motion to dismiss(#637) is DENIED;

(4) Joseph M. Hirko's motions to dismiss (duplicatively filed as#639, #685) are GRANTED;

(5) Kenneth D. Rice's motion to dismiss (#640) is DENIED;

(6) Richard A. Causey'S motion to dismiss (#642) is DENIED;

(7) Jeffrey McMahon's motion to dismiss (#644) is DENIED;

(8) James V. Derrick, Jr.'s motion to dismiss (#649) is GRANTED;

(9) Kevin P. Hannon's motion to dismiss (#655) is DENIED;

(10) Kenneth L. Lay's motion to dismiss (#683) is DENIED; and

(11) Jeffrey K. Skilling's motion to dismiss (#718) is DENIED. The Court further

ORDERS that the discovery stay under the PSLRA is hereby LIFTED. Lead Plaintiff shall confer with counsel for all parties and submit a joint proposed schedule for discovery in *Newby* and *Tittle* and for any additional briefing related to class certification in *Newby* or, if necessary, request a hearing before the Court to establish one. The Court will set a class certification hearing after reviewing that briefing.

SIGNED at Houston, Texas, this 23rd day of April, 2003.

MELINDA HARMON
UNITED STATES DISTRICT JUDGE